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16.0 SALE OF STOCK & ELECTION OF IRC §338(H)(10)

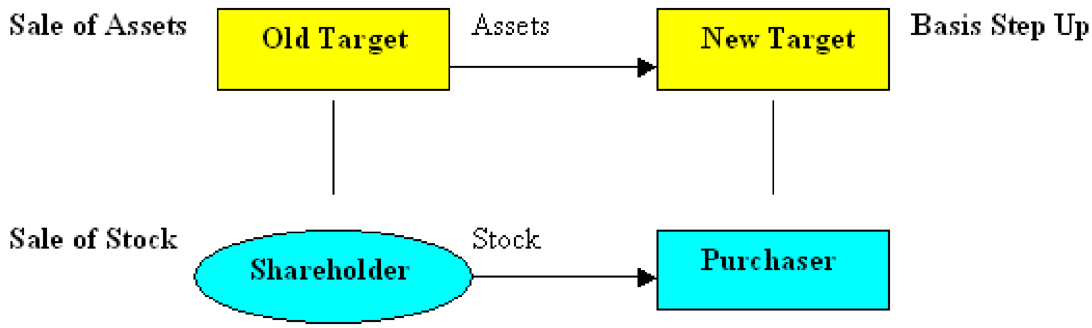
16.1 CORPORATION ACQUISITION – IN GENERAL

There are two basic ways to acquire a corporation – (1) stock purchase and (2) asset purchase.

Stock purchase is simple. In general, a purchaser buys stock from shareholders of a corporation. The selling shareholders treat the transaction as sale of stock and realize capital gain or loss. The selling shareholder's amount realized is the stock selling price. The adjusted basis is the adjusted basis in the stock sold. When the stock transaction is completed, the purchaser owns the target corporation. The target corporation continues to operate as if nothing had happened. The basis of the assets held by the target corporation (now owned by the new shareholder) stays the same.

When a purchaser purchases the target assets instead, the purchaser's basis in the assets acquired is the purchaser's cost allocated among the assets pursuant to Internal Revenue Code (IRC) §1060. Therefore, the basis of assets held by the purchaser is stepped up by the amount of gain that is realized by the target corporation (providing the purchase price of assets is more than the adjusted basis of assets). Having higher basis is beneficial to taxpayers for various reasons. However, this method can be quite troublesome for the seller and the purchaser – such as sales tax, property title transfer, relocation of tangible assets, etc.

One way to have the ease of a stock purchase together with the benefit of basis step-up is for the purchaser to purchase stock and to elect IRC §338. The election of IRC §338 treats the stock sale as if the target's assets were sold to an unrelated person (New Target). The deemed sale of assets usually gives basis step-up in the assets deemed sold. For this purpose, the target corporation must realize gain on deemed sale of assets. In addition, the selling shareholder must report gain on sale of stock. Therefore, electing IRC §338 results in double taxation.



To avoid double taxation, if the parties agree and if certain requirements are met, the selling party and the purchaser can make a joint election of IRC §338(h)(10).

Note that in a 338 election (made under 338(g)), the purchaser only makes the election. For a 338(h)(10) election, both the buyer and seller must jointly elect. In order to make a valid election for California tax purposes, the person or entity making the election must be a California taxpayer for California purposes. For a corporation to be considered a California taxpayer, it must be incorporated in California, qualified to do business in California, conducting business in California, or a member of a combiner report group with at least one member that is a California taxpayer. See Revenue and Taxation Code (R&TC) §23037.

For detailed discussion of who is eligible to make a 338 election and a 338(h)(10) election for California purposes, see Technical Advice Memorandum 200206 (September 15, 2000).

16.2 IRC §338(H)(10) - OVERVIEW

The election of IRC §338(h)(10) treats the stock transaction as if Old Target, transferred all of its assets to an unrelated person (New Target) in exchange for consideration that includes the discharge of liabilities in a single transaction at the close of the acquisition date and then transferred all of its assets (the sales proceeds) to the selling shareholders and ceased to exist. (Treas. Reg. §1.338(h)(10)-1(d)(3) and Treas. Reg. §1.338(h)(10)-1(d)(4)) The stock transaction is ignored for tax purposes.

Note that under Treas. Reg. §1.338(h)(10)-1(d)(2), New Target remains liable for the new tax liabilities of Old Target, including the tax liability for the deemed sale. In the case of tiered targets, the deemed asset sale of the parent corporation is considered to precede that of its subsidiary under Treas. Reg. §1.338(h)(10)-1(d)(3)(ii) and the deemed transfer of the subsidiary precedes the deemed transfer of the parent under Treas. Reg. §1.338(h)(10)-1(d)(4)(ii).

The transfer of the sales proceeds to the selling shareholders may be treated, for example (Treas. Reg. §1.338(h)(10)-1(d)(4)):

- As a distribution as part of a reorganization,
- As a distribution or one in a series of distributions in redemption of stock as part of a plan of liquidation, or
- As a part of a circular cash flow.

Treas. Reg. §1.338(h)(10)-1(d)(4) states that "[I]n most cases, the transfer will be treated as a distribution in complete liquidation to which [Internal Revenue Code] §336 or 337 applies."

The transaction is viewed as if actual asset sale occurred for all purposes of determining income or franchise tax. If the federal regulations fail to address a particular situation, the issue should be analyzed as if the deemed sale transactions actually occurred. (Treas. Reg. §§1.338(h)(10)-1(d)(4) and 1.338(h)(10)-1(d)(9))

California has conformed to IRC §338 by virtue of its conformity to Subchapter C in R&TC §24451.

16.3 LAW UPDATES

The regulations under IRC §338 contain explanations and examples of how the 338 rules apply, including the IRC §338(h)(10) rules and their application to S corporation targets. R&TC §23051.5(d) states "regulations promulgated in final form or issued as temporary regulations by the 'secretary' shall be applicable as regulations issued under this part to the extent that they do not conflict with this part or with regulation issued by the Franchise Tax Board." Final or temporary federal regulations apply so long as California has conformed to the underlying law. The last date of conformity listed in R&TC §17024.5 is January 1, 1998. Even though final or temporary regulations are promulgated after January 1, 1998, those regulations still apply so long as they support a federal code section to which our general conformity date applies. If a federal code section was enacted before January 1, 1998 and California conformed to that code sections, final or temporary regulations promulgated after the date of conformity still apply so long as the underlying statute has not been changed.

Treas. Reg. §1.338(h)(10)-1 applies to IRC §338(h)(10) elections in addition to the rules of Treas. Reg. §1.338-1 through Treas. Reg. §1.338-10, unless a rule within Treas. Reg. §1.338(h)(10)-1 overrides those general rules. (Treas. Reg. §1.338(h)(10)-1(a))

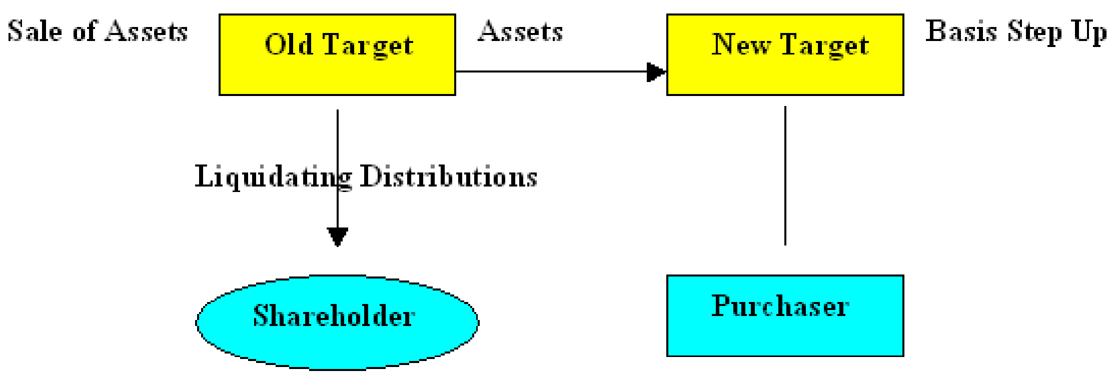
Temporary regulations were promulgated in a piecemeal fashion from 1982 through 1991, with many changes being made during that time period. (See T.D. 7855, 1982-2 C.B. 79, T.D. 7942, 1984-1 C.B. 93, T.D. 7975, 1984-2 C.B. 81, T.D. 8021, 1985-1 C.B. 96, T.D. 8068, 1986-1 C.B. 165, T.D. 8072, 1986-1 C.B. 111, T.D. 8074, 1986-1 C.B. 126, T.D. 8088, 1986-1 C.B. 52, T.D. 8092, 1986-2 C.B. 49, T.D. 8215, 1988-2 C.B. 304 and T.D. 8339, 1991-1 C.B. 52.) Regulations finalized in 1994 apply generally to the acquisition of targets on or after January 20, 1994 but before January 6, 2000. (See T.D. 8515, 1994-1 C.B. 89 and T.D. 8516, 1994-1 C.B. 119.) Many of the 1994 regulations were re-designated or reissued in temporary form in January of 2000. (See T.D. 8858, 2000-4 I.R.B. 332.) For acquisitions occurring after January 5, 2000 but before March 16, 2001, these temporary regulations apply.

In February of 2001, the temporary regulations were made final and apply to qualified stock purchases occurring after March 15, 2001. (See T.D. 8490, 66 Fed. Reg. 9925 (2/13/01)) References to the regulations contained within this manual are to the final regulations effective March 15, 2001.

For qualified stock purchases occurring prior to that date, please refer to the temporary or final regulations in effect at that time. Each version of the regulations contains changes, some of which are significant. Therefore, it is important to make sure that the correct regulations are used.

16.4 MECHANICS OF IRC §338(H)(10)

Qualified taxpayers can make a joint election to treat the stock transaction as if the target corporation (Old Target) sold assets to another corporation (New Target), followed by the termination of Old Target's existence. Therefore, there are two tax transactions that must be considered – (1) deemed sale of assets by the target corporation and (2) deemed transfer of the sales proceeds to the shareholders and cessation of the existence of the corporation (typically via a liquidation). The stock sale is ignored. (IRC §338(h)(10)(A) and Treas. Reg. §1.338(h)(10)-1(d)(5)(iii)) When these transactions are completed, the purchaser owns the New Target, which holds the Old Target's assets with a higher basis.



16.5 QUALIFICATIONS OF TAXPAYER AND EVENTS

The election of IRC §338(h)(10) may be made when a qualified purchasing taxpayer purchases stock of a qualified target corporation in a qualified stock purchase.

Qualified Purchaser

A qualified purchaser must be a corporation. (IRC §§338(d)(1) & (3)) If an individual establishes a corporation and has the corporation purchase stock from a qualified seller, the purchaser still qualifies. (Treas. Reg. §1.338-3(b)(1))

An S corporation can be a purchaser. Former IRC §1371(a)(2) stated that for purposes of subchapter C transactions, an S corporation was treated as an individual. Therefore, it could not be a purchaser in an IRC §338 transaction. IRC §1371(a)(2) was repealed in 1996, thus allowing S corporations to be purchasers. Moreover, the prohibition against S corporations being members of an affiliated group was also repealed such that S corporations may own subsidiaries.

To be eligible to make an IRC §338(h)(10) election for California purposes, a purchaser must be a California taxpayer or a member of a combined reporting group that has at least one member that is a California taxpayer. (Cal. Code Reg. §25106.5-3) Note that the determination of the purchaser's eligibility to make an election is made after the stock purchase, not at the stock purchase.

For detailed discussion of who is eligible to make an IRC §338 election and an IRC §338(h)(10) election for California purposes, see Technical Advice Memorandum 200206 (September 15, 2000).

Qualified Seller

A qualified seller must be a member of a selling consolidated group, a selling affiliate, or an S corporation shareholder. (Treas. Reg. §1.338(h)(10)-1(c)) It must be a California taxpayer or a member of a combined reporting group that has at least one member that is a California taxpayer. If the S corporation owns a subsidiary that is a Target, then the S corporation could be a qualified seller. Changes in IRC §1361(b) in 1996 resulted in the ability of S corporations to own subsidiaries.

Qualified Events

a. 80% ownership requirement

A purchasing corporation must purchase 80% or more of a target stock within a 12-month period. (IRC §338(d)(3)) The 80% requirement can be met by redemption of stock by a target corporation's shareholder, if the redemption results in the purchasing corporation's holding 80% or more of outstanding target stock. The last day to meet the 80% requirement is the date of purchase.

Note that under Treas. Reg. §1.338(h)(10)-1(d)(1), an automatic election is deemed to have been made for nonrecently purchased target stock. Also, the 12-month requirement may be extended under IRC §338(e)(3) and (i). (Treas. Reg. §1.338-8(j)(2))

Treas. Reg. §1.338(h)(10)-1(d)(3) states that the S election continues in effect through the close of the acquisition date, including the time of the deemed asset sale and termination of Old Target, notwithstanding IRC §1362(d)(2)(B). Since the S corporation target is acquired by a qualified purchaser that must be a corporation, the S election will be automatically terminated under IRC §1362(d)(2)(B) because corporations are not permitted to be S corporation shareholders.

b. Qualified Purchase

To qualify, the purchaser and the seller must be unrelated, and the seller must recognize all of the gain or loss on the sale under IRC §338(h)(3). (See Treas. Reg. §§1.338-3(b)(2) and (3) for a discussion of the term "purchase" and the meaning of "related.") Thus, IRC §351, IRC §354, IRC §355, and IRC §356 transactions are not qualified purchases of stock. (IRC §338(h)(3))

c. Post Acquisition Event

Because the law requires the purchaser to be a true purchaser, if the purchaser existed only for the purpose of making the election, the qualification of the transaction may be questionable. (Treas. Reg. §1.338-3(c)(2)) For example, a taxpayer establishes a corporation to acquire another corporation and elects IRC §338(h)(10). If immediately after the election another corporation acquires the purchasing corporation, the purchasing corporation may be a transitory subsidiary and may not be a qualified purchaser. To determine who the true purchaser is, we may use "step transaction" analysis.

If an individual taxpayer wants to acquire stock of a target and take advantage of
IRC §338, the individual may form a corporation (New P) to acquire the stock. New P may not be considered the true purchaser if, for example, New P is merged into the target, liquidated or otherwise disposed of after the purported qualified purchase. (Treas. Reg. §1.338-3(b)(1)) The same would apply for a partnership that wants to make a qualified purchase.

Elimination of the target (by liquidation, for example) on or after the acquisition date will not invalidate the IRC §338 election. (Treas. Reg. §1.338-3(c)(1))

16.6 MANNER OF MAKING THE ELECTION

The election must be made by the 15^{th} day of the 9^{th} month after the acquisition date by filing federal Form 8023. (Treas. Reg. §1.338(h)(10)-1(c)(2)) Note that as long as taxpayers filed Form 8023 timely, the election is valid.

The purchaser and the S corporation shareholders must jointly make the election. S corporation shareholders who do not sell their stock must also consent to the election. (Treas. Reg. §1.338(h)(10)-1(c)(2)) Federal Form 8023 did not clearly reflect the need for the non-selling shareholders to sign the form. Treas. Reg. §1.338(i)-1 states that if the non-selling shareholders failed to sign the September 1997 revision of Form 8023, the IRC §338(h)(10) election will not be invalidated if the S corporation and all its shareholders (including non-selling shareholders) report the tax consequences with the results under IRC §338(h)(10).

An IRC §338(h)(10) election is irrevocable. (Treas. Reg. §1.338(h)(10)-1 (c)(3)) If an IRC §338(h)(10) election is made, then an IRC §338 election is deemed made. (Treas. Reg. §1.338(h)(10)-1(c)(3)) If a valid election is made for federal tax purposes, the election automatically applies for California tax purposes under R&TC §17024.5(e) and R&TC §23051.5(e).

In general, the purchaser and the seller could jointly elect out of the federal IRC §338(h)(10) election for California, if both parties make the election out for California within the time frame stated above, as provided by R&TC §23051.5(e)(3). The result of California election out would be reflected as California adjustments on the Old Target's tax return. However, for transactions on or after January 1, 1998, S corporations or their shareholders are not allowed to elect out of the federal IRC §338(h)(10) election for California under R&TC §23806(a) and (b).

If a stock transaction does not qualify for the IRC §338(h)(10) election (an invalid election is made), it cannot qualify for the regular IRC §338 election. The deemed §338 election is invalid as well. (Treas. Reg. §1.338(h)(10)-1(c)(4)) When an invalid election is made, the transaction is treated as a simple stock transfer. Therefore, the New Target does not receive basis step up.

16.7 TRANSACTIONS – PURCHASING CORPORATION, NEW TARGET, OLD TARGET CORPORATION, AND SELLING SHAREHOLDERS

As explained in S Corp 160400 (Mechanics of IRC §338(h)(10)), there are four parties to the transaction – Old Target, Selling Shareholders, New Target, and Purchasing Corporation. Selling Shareholders sell Old Target stock to Purchasing Corporation, making Purchasing Corporation the new owner of New Target.

To reflect the stock transaction with election of IRC §338(h)(10) on their books, each party must do the following:

16.7.1 Purchasing Corporation
16.7.2 New Target
16.7.3 Old Target Corporation
16.7.4 Selling Shareholders

16.7.1 Purchasing Corporation

A purchasing corporation must determine the grossed-up basis of Target's stock. The grossed-up basis of Target's stock is the cost incurred to purchase stock including capitalized purchasing costs. (IRC §1012)

Example A

Susan (a sole shareholder of an S corporation, S Mart) sold all of issued and outstanding S-Mart stock to P-Mart (a C corporation) for $1 million. A valid, joint IRC §338(h)(10) election was made regarding the stock sale. P-Mart paid an additional $60,000 to close the stock purchase.

As a new stockholder, P-Mart's computes its grossed-up basis of S-Mart stock as follows:

Stock purchase price	$1,000,000
Capitalized cost	60,000
Grossed-up basis of S-Mart stock	$1,060,000

The $1,060,000 is P-Mart's basis in S-Mart stock.

16.7.2 New Target

New Target's basis in asset is the amount for which New Target is deemed to have purchased and is called the adjusted grossed-up basis (AGUB). (IRC §338(b)(2) and Treas. Reg. §§1.338(h)(10)-1(d)(2) and 1.338-5(a))

The AGUB is the sum of (Treas. Reg. §1.338-5(b)(1)):

- The grossed-up basis in the purchasing corporation's recently purchased Target stock (IRC §338(b)(1)(A) and Treas. Reg. §1.338-5(c));
- The purchasing corporation's basis in non-recently purchased Target stock (IRC §338(b)(1)(B) and Treas. Reg. §1.338-5(d)); and
- The liabilities of New Target (IRC §338(b)(2) and Treas. Reg. §1.338-5(e)).

Recently purchased stock is stock held by the Purchaser on the acquisition date and purchased by Purchaser during the 12-month acquisition period. (IRC §338(b)(6)(A) and (h)) Non-recently purchased stock is stock held by the Purchaser on the acquisition date that was not purchased during the 12-month acquisition period. (IRC §338(b)(6)(B) and (h))

If a taxpayer or an affiliate of the taxpayer makes a 338 election for acquired stock, IRC §338(e) and Treas. Reg. §1.338-8 require that other asset and stock purchases made a year before or after the 12 month acquisition period be treated consistently in that a taxpayer cannot have 338 treatment for one purchase and not another and vice versa. Under the old rules, the IRS could deem certain transactions to be subject to IRC §338. Under the new regulations, assets acquired during the consistency period may be required to take a carry over basis rather than a stepped up basis. If there are multiple acquisitions of stock or assets of a target or target affiliate by a purchaser or purchasing affiliate, the consistency rules need to be looked at.

1. The grossed-up basis in the purchasing corporation's recently purchased Target stock (if Target has a single class of outstanding stock) is the total price that Purchasing Corporation would have paid for all outstanding Target stock, except for the amount allocated to the non-recently purchased stock.

The basis of recently purchased stock is determined at the beginning of the day after the acquisition date without regard to acquisition costs. This basis is then multiplied by a fraction, the numerator of which is 100 minus the number that is the percentage of Target stock (by value, determined on the acquisition date) attributable to the Purchaser's non-recently purchased stock, and the denominator of which is the number equal to the percentage of Target stock (by value, determined on the acquisition date) attributable to the Purchaser's recently purchased stock. Acquisition costs that Purchaser incurred in connection with its purchase of recently purchased stock, such as brokerage commissions, are then added in to determine the grossed up basis of recently purchased stock. (Treas. Reg. §1.338-5(c))

If Target was an S corporation, the grossed-up basis in the purchasing corporation's recently purchased Target stock would be the stock sale price plus any capitalized purchasing cost. This is because if the Target is an S corporation, the first time that its stock is purchased by a corporation in a 338 transaction, the S election will be terminated under IRC §1362(d)(2)(B) because it will have a corporate shareholder. Treas. Reg. §1.338(h)(10)-1(d)(3) specifies that if an S corporation is a target in an IRC §338(h)(10) transaction, the S election will continue in effect through the close of the acquisition date, including the time of the deemed asset sale and the deemed transfer, notwithstanding IRC §1362(d)(2)(B).

Note, however, that the seller or purchaser could be an S corporation and the acquisition or sale of a subsidiary of an S corporation will not terminate the parent corporation's S election.

2. The purchasing corporation's basis in non-recently purchased target stock is Purchaser's basis in that stock, unless it makes an election under IRC §338(b)(3).

If Target is an S Corporation, there will be no non-recently purchased stock because the acquisition of the stock of an S corporation by a corporation will terminate the S election under IRC §1362(d)(2)(B) (the S corporation cannot have a corporation as a shareholder). In order to qualify for the 338 election, Purchaser must be a corporation.

3. The liabilities of new target are Target's liabilities assumed by New Target. (Treas. Reg. §1.338-5(e))

AGUB is initially determined at the beginning of the day after the date of the acquisition of Target. (Treas. Reg. §1.338-5(b)(2)(i)) AGUB may need to be redetermined if there is an increase or decrease, for example, in the amount paid for the stock. See Treas. Reg. §1.338-5(b)(2)(ii) for a discussion regarding the redetermination of AGUB.

Once New Target determines the AGUB, New Target must allocate the AGUB among each class of assets and then to each asset in accordance with Treas. Reg. §1.338-6 and Treas. Reg. §1.338-7. (Treas. Reg. §1.388(h)(10)-1(d)(2)) The method described under Treas. Reg. §1.338-6 is called Residual Method.

Using the Residual Method, AGUB is assigned to each class of asset, from Class I through Class IV, up to the fair market value. Refer to the valuation training material for the discussion of FMV and how to determine FMV. Then, the remainder is assigned to Class V (Goodwill). Assets are classified as follows:

Class I:	Cash and Demand Deposit
Class II:	Marketable Securities, CD's Foreign Currency
Class III:	All others except Classes I, II, IV, and V
Class IV:	All intangibles except Goodwill
Class V:	Goodwill

Once AGUB is allocated among the five classes of assets, New Target must further apportion the new basis (assigned to each class) to each asset within a class proportionately. The amount of basis applied to each asset is the opening balance of the New Target balance sheet.

Example A

In addition to the facts in Example A of S Corp 160701, S-Mart had $100,000 A/P and a $200,000 Long-Term Loan at the time of the stock sale. New S-Mart computes the adjusted grossed-up basis (AGUB) in the assets deemed acquired from Old S-Mart as follows:

AGUB:	Grossed-up basis of S-Mart stock	$1,060,000
	S-Mart's liabilities assumed (A/P $100,000, N/P $200,000)	$300,000
		$1,360,000

Also, Old S-Mart had the following assets at the time of the stock sale:

Assets	**A/B**	**FMV**
Cash	$50,000	$50,000
Inventory	$150,000	$150,000
A/R	$100,000	$100,000
N/R	$20,000	$20,000
Equipment	$140,000	$160,000
Land/Building	$170,000	$300,000
Total Assets	$630,000	$780,000

Using the residual method, New S-Mart allocates the AGUB among each class of assets as follows:

Class	**Assets**	**FMV**	**Allocation**	**Residual**
I	Cash	$50,000	$50,000	$1,310,000
II	N/A			
III	Inventory	$150,000		
	A/R	$100,000		
	N/R	$20,000		
	Equipment	$160,000		
	Land/Building	$300,000	$730,000*	$580,000
IV	N/A			
V	Goodwill		$580,000	$0
Total Assets			$1,360,000	

* $730,000 will be allocated to each class III asset proportionately.
New S-Mart's opening balance sheet should look like this...

Assets		**Liab. & Equity**	
Cash	$50,000	N/P	$200,000
		A/P	$100,000
Inventory	$150,000	Total Liab	$300,000
A/R	$100,000		
N/R	$20,000		
Equipment	$160,000		
Land/Building	$300,000		
Goodwill	$580,000	Equity	$1,060,000

Total Assets	$1,360,000	Total Liab. & Equity	$1,360,000

As explained in S Corp 160200, S-Mart's assets received a basis step-up when the transaction was completed.

Example B

Using Example A of S Corp 160702, but if S-Mart stock was sold for $550,000, the acquisition cost was $20,000, and Old Target's liabilities were $100,000 (A/P $30,000, N/P $70,000):

AGUB:	Grossed-up basis of S-Mart stock	$570,000
	S-Mart's liabilities assumed (A/P $30,000 & N/P $70,000)	$100,000
		$670,000

At the time of stock sale, Old S-Mart had the following assets:

Assets	A/B	FMV
Cash	$50,000	$50,000
Inventory	$150,000	$150,000
A/R	$100,000	$100,000
N/R	$20,000	$20,000
Equipment	$140,000	$160,000
Land/Building	$170,000	$300,000
Total Assets	$630,000	$780,000

Using the residual method, New S-Mart allocates the $670,000 AGUB among each class of assets as follows:

Class	Assets	FMV	Allocation	Residual
I	Cash	$50,000	$50,000	$620,000
II	N/A			
III	Inventory	$150,000		
	A/R $100,000			
	N/R	$20,000		
	Equipment	$160,000		
	Land/Building	$300,000	$620,000*	$0
IV	N/A			
V	Goodwill		$0	$0
	Total Assets		**$670,000**	

* New S-Mart allocates the $620,000 to each asset proportionately as follows:

Class III Assets	FMV	Ratio	Allocation
Inventory	$150,000	0.20547	$127,397
A/R	$100,000	0.13698	$84,932
N/R	$20,000	0.02739	$16,986
Equipment	$160,000	0.21917	$135,890
Land/Building	$300,000	0.41095	$254,795
Total Class III Assets	$730,000		$620,000

New S-Mart's balance sheet should look like this…

Assets		Liab. & Equity	
Cash	$50,000	A/P	$30,000
Inventory	$127,397	L/T Loan	$70,000
A/R	$84,932	Total Liab	$100,000
N/R	$16,986		
Equipment	$135,890		
Land/Building	$254,795	Equity	$570,000
Total Assets	$670,000	Total Liab. & Equity	$670,000

As of the day after the acquisition date, New Target is generally treated as a new corporation, unrelated to Old Target, that has no tax attributes (including no net operating losses and no earnings and profit). (Treas. Reg. §1.338-1(b)(1).) New Target may make new accounting period and method elections. (Treas. Reg. §1.338-1(b)(1)) For non-income/franchise tax purposes, such as payroll tax, New Target is a continuation of Old Target. (Treas. Reg. §1.338-1(b)(2))

16.7.3 Old Target Corporation

Old Target Corporation must book transactions as if it had sold all of its assets to an unrelated corporation (New Target) in exchange for consideration that includes the discharge of liabilities in a single transaction at the close of the acquisition date, transferred the proceeds to Seller, and terminated its existence. (Treas. Reg. §1.338(h)(10)-1(d)(3) and Treas. Reg. §1.338-10(a)(1)) Therefore, except as provided in Treas. Reg. §1.338(h)(10)-1(d)(8) (regarding the installment method), Old Target recognizes all the gain realized on the deemed sale of assets and report the result as an S corporation on its final year return. (Treas. Reg.

§1.338(h)(10)-1(d)(3) and Treas. Reg. §1.338-10(a)(1) and (5)) The return is due on the 15th day of the 3rd month following the month in which the acquisition occurs. (Treas. Reg. §§1.338(h)(10)-1(d)(3)(i). Target's S election continues in effect through the close of the acquisition date (including the time of the deemed asset and the deemed transfer) notwithstanding IRC §1362(d)(2)(B).

As mentioned before, New Target is treated as a new corporation that is unrelated to Old Target and receives no tax attributes from Old Target. (Treas. Reg. §1.338-1(b)(1))

The gain or loss on the deemed sale of each asset is determined by reference to the aggregate deemed sales price (ADSP). (Treas. Reg. §§1.338(h)(10)-1(d)(3)(i) and 1.338-4.) ADSP is the amount for which Target is deemed to sell its assets. (Treas. Reg. §1.338-4(a)) ADSP is the sum of the grossed-up amount realized on the sale to Purchaser of Purchaser's recently purchased Target stock (as defined in IRC §338(b)(6)(A)) and the liabilities of Old Target. (Treas. Reg. §1.338-4(b)(1)) ADSP is initially determined at the beginning of the day after the acquisition date of Target. (Treas. Reg. §1.338-4(b)(2)(ii)) ADSP may need to be redetermined, for example, because of an increase or decrease in the amount realized or because liabilities not originally taken into account are subsequently taken into account. (Treas. Reg. §1.338-4(b)(2)(ii)) ADSP may not be applied in such a way as to contravene other applicable rules. (Treas. Reg. §1.338-4(f))

For purposes of calculating ADSP, the liabilities of Old Target are measured as of the beginning of the day after the date of acquisition. In order to be taken into account in ADSP, a liability must be a liability of Target that is properly taken into account in amount realized under general principles of tax law that would apply if Old Target had sold its assets to an unrelated person for consideration that included the discharge of its liabilities. (Treas. Reg. §§1.338-4(d)(1) and 1.1001-2(a))

ADSP is then allocated among Target's assets in accordance with Treas. Reg. §1.338-6 to determine the amount for which each asset is deemed to have been sold. (Treas. Reg. §1.338-4(a)) If ADSP is redetermined, then Treas. Reg. §1.338-7 is used to allocate the redetermined ADSP.

Once the ADSP is computed, Old Target allocates ADSP among the assets deemed sold to determine the character and the amount of gain/loss on each asset. (Treas. Reg. §§1.338(h)(10)-1(d)(3)(i) and 1.338-6) The method used (the residual method) is the same as the method used by New Target in allocating AGUB among the deemed purchased assets from Old Target.

If an IRC §338 election (instead of IRC §338(h)(10) was made for an S corporation Target, Old Target must file tax return reporting the deemed sale of assets as a C corporation, under Treas. Reg. §1.338-10(a)(3). This is because the S election is terminated when the corporate purchaser acquires the stock. Special rules apply to extend the S election for IRC §338(h)(10) elections until after the deemed sale and transfer transactions (Treas. Reg. §1.338(h)(10)-1(d)(3)(i)), but no such rule exists for an IRC §338(g) election.

If no IRC §338(h)(10) election were made at the time of the stock sale, there would be only one transaction – a sale of stock by selling shareholders to a purchasing corporation. Selling shareholders would have gain or loss on sale of stock, and Purchasing Corporation would have cost basis in Target's stock. If Target Corporation was an S corporation, Target Corporation's S status would be revoked under IRC §1362(d)(2)(B).

Example A

Using the facts in Example A of S Corp 160702, Old S-Mart computes the aggregate deemed sales price (ADSP) of the assets deemed sold to New S-Mart. The selling cost incurred for the stock sale was $30,000, and liabilities assumed by New S-Mart totaled $300,000.

ADSP:	Grossed-up basis of S-Mart stock	$1,060,000
	S-Mart liabilities (A/P $100,000, N/P $200,000)	$300,000
	Acquisition cost incurred by the purchasing corporation	($60,000)
	Selling cost incurred by the seller	($30,000)
		$1,270,000

Old S-Mart allocates the $1,270,000 among the assets held at the time of stock sale:

Assets	A / B	FMV
Cash	$50,000	$50,000
Inventory	$150,000	$150,000
A/R	$100,000	$100,000
N/R	$20,000	$20,000
Equipment	$140,000	$160,000
Land/Building	$170,000	$300,000
Total Assets	$630,000	$780,000

Using the residual method, New S-Mart first allocates the $1,270,000 ADSP among each class of assets:

Class	Assets	FMV	Allocation	Residual
I	Cash	$50,000	$50,000	$1,220,000
II	N/A			
III	Inventory	$150,000		
	A/R	$100,000		
	N/R	$20,000		
	Equipment	$160,000		
	Land/Building	$300,000	$730,000*	$490,000
IV	N/A			
V	Goodwill		$490,000	$0
	Total Assets		$1,270,000	

* $730,000 will be allocated to each class III asset proportionately.

Old S-Mart computes the amount and the character of gain on sale of each asset as shown below:

Assets	A / R	A / B	Gain / (Loss)
Cash	$50,000	$50,000	
Inventory	$150,000	$150,000	
A/R	$100,000	$100,000	
N/R	$20,000	$20,000	
Equipment	$160,000	$140,000	$20,000 Gain
Land/Building	$300,000	$170,000	$130,000 Gain
Goodwill	$490,000	$0	$490,000 Gain
Total Assets	**$1,270,000**	**$630,000**	**$640,000**

Auditors must pay special attention to the types of gains or losses from the deemed sale of assets. They may trigger additional tax issues (such as built in gains tax), as discussed later in this chapter.

Example B

Using the facts in Example B of S Corp 160702, S-Mart stock was sold for $550,000, the acquisition cost was $20,000, and Old Target's liabilities were $100,000 (A/P $30,000, N/P $70,000):

ADSP:	Grossed-up basis of S-Mart stock	$570,000
	S-Mart liabilities assumed (A/P $30,000 & N/P $70,000)	$100,000
	Acquisition cost incurred by the purchasing corporation	($20,000)
	Selling cost incurred by the seller	($30,000)
		$620,000

At the time of stock sale, Old S-Mart had the following assets:

Assets	A/B	FMV
Cash	$50,000	$50,000
Inventory	$150,000	$150,000
A/R	$100,000	$100,000
N/R	$20,000	$20,000
Equipment	$140,000	$160,000
Land/Building	$170,000	$300,000
Total Assets	$630,000	$780,000

Using the residual method, Old S-Mart allocates the $620,000 ADSP among each class of assets as follows:

Class	Assets	FMV	Allocation	Residual
I	Cash	$50,000	$50,000	$570,000
II	N/A			
III	Inventory	$150,000		
	A/R	$100,000		
	N/R	$20,000		
	Equipment	$160,000		

	Land/Building	$300,000	$570,000*	$0
IV	N/A			
V	Goodwill		$0	$0
	Total Assets		$620,000	

* Old S-Mart allocates the $570,000 to each asset proportionately as follows:

Class III Assets	**FMV**	**Ratio**	**Allocation**
Inventory	$150,000	0.20547	$117,123
A/R	$100,000	0.13698	$78,082
N/R	$20,000	0.02739	$15,616
Equipment	$160,000	0.21917	$124,932
Land/Building	$300,000	0.41095	$234,247
Total Class III Assets	$730,000		$570,000

Old S-Mart computes the amount and the type of gain or loss on sale of each asset as shown below:

Assets	**A / R**	**A / B**	**Gain / (Loss)**
Cash	$50,000	$50,000	
Inventory	$117,123	$150,000	
A/R	$78,082	$100,000	
N/R	$15,616	$20,000	
Equipment	$124,932	$140,000	($15,068)
Land/Building	$234,247	$170,000	$64,247
Total Assets	$630,000	$640,000	

Auditors must pay special attention to the types of gains or losses from the deemed sale of assets. They may trigger additional tax issues, as discussed later in this chapter.

16.7.4 Selling Shareholders

The S corporation shareholders, whether or not they sell their stock, take their pro rata share of the deemed sale tax consequences into account under IRC §1366 and increase or decrease their basis in the Target stock under IRC §1367. (Treas. Reg. §1.338(h)(10)-1(d)(5)(i)) This occurs because the

S corporation Target will report the deemed gain on its final S corporation tax return. (Treas. Reg. § 1.338(h)(10)-1(d)(3)(i)) The selling S shareholders treat the transaction as if (after the deemed sale and before the close of the acquisition date) Old Target transferred the assets (the sales proceeds) to the shareholders. In most cases, the transfer of the assets (the sales proceeds) will be treated as a distribution in complete liquidation to which IRC §331 or IRC §332 applies. (Treas. Reg. §1.338(h)(10)-1(d)(5)(i)) Therefore, shareholders realize capital gain or loss on the exchange. The amount realized is the stock price, and the adjusted basis is the shareholders' basis in the stock. In computing the gain/loss, the shareholders basis in the stock should be increased by the flow-through gain/loss recognized on deemed sale of assets by the corporation, pursuant to IRC §1367(a). Often, because of the increase in stock basis, there will be no gain or loss recognized by the shareholders on the deemed liquidation.

As mentioned before, an IRC §338(h)(10) election is irrevocable. If an IRC §338(h)(10) election is made, then an IRC §338 election is deemed made. If a stock transaction does not qualify for the IRC §338(h)(10) election (an invalid election is made), it cannot qualify for the regular IRC §338 §election. Therefore, the deemed IRC §338 election is invalid as well. If an invalid election is made, the transaction is treated as a simple stock transfer. Therefore, the New Target does not receive basis step up, and the selling shareholders compute gain/loss pursuant to IRC §1001(a).

S corporation shareholders who do not sell their stock of Target are treated as acquiring the retained stock on the day after the acquisition date for its fair market value. (Treas. Reg. §1.338(h)(10)-1(d)(5)(ii)) The holding period for the stock starts on the acquisition date. The fair market value of the Target stock equals the grossed-up amount realized on the sale to the Purchaser of recently purchased Target stock. The S shareholders recognize no gain or loss on the sale of Target stock, although gain or loss may be recognized in the deemed transfer. (Treas. Reg. §1.338(h)(10)-1(d)(5)(iii))

Gain or loss on the actual sale of Target stock is ignored in an IRC §338(h)(10) transaction. (IRC §338(h)(10)(A) and Treas. Reg. §1.338(h)(10)-1(d)(5)(iii))

Example A

Using the facts in Examples A of S Corp 160701, S Corp 160702, S Corp 160703, Susan sold all of issued and outstanding S-Mart stock to P-Mart for $1 million. A valid, joint IRC §338(h)(10) election was made regarding to the stock sale. Old S-Mart recognized $640,000 gain (no built-in gains) on deemed sale of assets and passed through the gain (along with other flow-through items) to Susan.

Susan's stock basis was $330,000, excluding effects of the IRC §338(h)(10) elections, but including all other flow-through items. Susan must recognize the $640,000 flow-through gain and increase her stock basis in Old S-Mart to $970,000.

Under IRC §331(a), Susan computes her gain on deemed liquidation of S-Mart as follows:

Amount Realized (Stock Price)	$1,000,000
Adjusted Basis (Stock Basis)	($970,000)
Capital Gain on Sale of Stock	$30,000

If Susan was a California resident, her total gain recognized from the IRC §338(h)(10) election should be $670,000 ($640,000 flow-through gain and $30,000 capital gain under IRC §331(a)).

Example B

Using the facts in Examples B of S Corp 160701, S Corp 160702, S Corp 160703, Susan sold all of issued and outstanding S-Mart stock to P-Mart for $550,000. A valid, joint IRC §338(h)(10) election was made regarding the stock sale. Old S-Mart recognized $49,179 gain (no built-in gains) on deemed sale of assets and passed through the gain (along with other flow-through items) to Susan.

Susan's stock basis was $330,000, excluding effects of the IRC §338(h)(10) election, but including all other flow-through items. Susan must recognize the $49,179 flow-through gain and increase her stock basis in Old S-Mart to $379,179.

Under IRC §331(a), Susan computes her gain on deemed liquidation of S-Mart as follows:

Amount Realized (Stock Price)	$550,000
Adjusted Basis (Stock Basis)	($379,179)
Capital Gain on Sale of Stock	$170,821

If Susan was a California resident, her total gain recognized from the 338(h)(10) election should be $220,000 ($49,179 flow-through gain and $170,821 capital gain under IRC §331(a)).

16.8 INSTALLMENT METHOD OF INCOME RECOGNITION

Treas. Reg. §1.338(h)(10)-1(d)(8) modifies the general rules for the tax consequences of IRC §338(h)(10) elections when applying the installment sales method and rules of IRC §453, IRC §453A and IRC §453B to Old Target in the deemed asset sale and to Old Target and its shareholders in the deemed liquidation (if applicable). Note that the regulations merely discuss the consequences of the application of the installment sales rules. The regulations do not override the requirements and limitations of the installment sales rules but merely describe the nature of the transactions when the installment sales rules apply in the context of an IRC §338(h)(10) transaction. California has generally conformed to the federal installment sales provisions, but because the last federal conformity date is as of January 1, 1998, any changes to the federal installment sales rules are not part of California law until the date is modified or there are specific conforming legislations. See Example 10 of Treas. Reg. §1.338(h)(10)-1(e).

With respect to the deemed asset sale, Old Target is treated as receiving New Target installment obligations, the terms of which are identical (except for the obligor) to the Purchasing Corporation's installment obligations issued for recently purchased stock of Target. Old Target is treated as receiving in cash all other consideration in the deemed asset sale other than the assumption of, or taking subject to, Old Target liabilities. For example, Old Target is treated as receiving in cash any amounts attributable to the grossing-up of amount realized under Treas. Reg. §1.338-4(c). The amount realized for recently purchased stock and ADSP are redetermined to reflect amounts paid under an installment obligation for the stock when the total payments under the installment obligation are greater or less than the amount realized.

With respect to a deemed liquidation, Old Target is treated as distributing (in the deemed liquidation) the New Target installment obligations that it is treated as receiving in the deemed asset sale. The S corporation shareholders are treated as receiving (in the deemed liquidation) the New Target installment obligations (that correspond to the Purchasing Corporation installment obligations they actually receive individually) in exchange for their recently sold stock. The New Target installment obligations may be recharacterized under other rules. For example, Treas. Reg. §1.453-11(a)(2) may, in certain circumstances, treat the New Target installment obligations deemed distributed by Old Target as if New Target issued them in exchange for the stock in Old Target owned by the S shareholders. The S shareholders are treated as receiving all other consideration in the deemed liquidation in cash.

See below for the mechanism of computing gain/loss by Old Target and the selling shareholders:

Example A

On 12/31/98 a sole shareholder of Target sold Target stock to a qualified purchasing corporation for $75 and received a $40 installment note and $35 cash. Target's liabilities assumed by the purchasing corporation were $25. Total Adj. Basis of assets deemed sold was $30. In year 2000 the shareholder collected $40 in full. Shareholders' basis in the stock was $20 immediately before the sale.

(a) Mechanics of an IRC §338(h)(10) with Installment Method of Income Recognition for Federal

1. Old Target reports $32.67 gain in 1998:

Amt. Realized	$100 ($75 + $25 liabilities assumed)
A/B of Assets	$30
Gross Profit	$70
Profit %	93.34% ($70/$75)*
Cash Receipt	$35
Gain	$32.67 *

- The profit percentage should be computed by dividing the gross profit by the contract price pursuant to IRC §453©.

* Gain (attributable to deemed sale of assets) flows through to shareholder under IRC §1366(a) and increases shareholders' basis under IRC §1367(a)(1).

2. Selling Shareholder reports $10.42 in 1998:

Under IRC §453(h)(1)(A), when a shareholder receives an installment note in a liquidation of corporation during the 12-month winding-down period, the shareholder must treat installment payments as payments in exchange for stock. Therefore, profit percentage must be computed and applied to cash receipts to compute gain on installment payments.

Amt. Realized	$75 (stock price)
A/B stock	$52.67 ($20 plus $32.67 flow-through gain)
Gross Profit	$22.33
Profit %	29.77% ($22.33 / $75)
Cash Receipt	$35
Rec. Gain	$10.42

3. Selling Shareholder receives $40 installment payment in 2000 and reports $11.91 gain in 2000:

Cash Receipt	$40
Profit %	29.77%
Rec. Gain	$11.91

(b) Mechanics of an IRC §338(h)(10) with Installment Method Transaction for California

California conforms to the federal provision of installment method of income recognition under IRC §453. However, for California Franchise Tax purpose, Target must report the unrecognized portion of the gain realized on deemed sale of assets in 1998, pursuant to R&TC §24672(a) as follows:

1. Old Target reports $70 gain in 1998:

Amt. Realized	$100 ($75 stock price + $25 liabilities assumed)
A/B	$30
Gross Profit	$70
Profit %	93.34% ($70/$75)
Cash Receipt	$35
Rec. Gain	$32.67 -- flow-through gain
CR & TC 24672(a) gain	$37.33 *Total reportable gain $70.00

* The $37.33 gain does not flow-through to shareholders since we allow the installment method of income recognition.

2. Selling Shareholder reports $10.42 in 1998:
As in the case for federal purposes, a shareholder must treat the installment payment as payment in exchange for stock.

Amt. Realized	$75 (Stock Price)
A/B stock	$52.67 ($20 plus $32.67 flow-through gain)
Gross Profit	$22.33
Profit %	$35
Cash Receipts	$10.42
Rec. Gain	29.77% ($22.33 / $75)

3. Selling Shareholder receives $40 installment payment in 2000 and reports $11.91 in 2000:

Cash Receipts	$40
Profit %	29.77%
Rec. Gain	$11.91

16.9 AUDIT ISSUES

As explained in previous sections, the IRC §338(h)(10) election treats Target as if it had sold all assets and then ceased to exist. All tax provisions that are applicable to sale of assets and a corporate liquidation apply to Old Target and to the selling shareholders. Auditors should be aware of the following issues:

Old Target's IRC §1245 recapture which reclassifies IRC §1231 gain to Ordinary Income
Old Target's Built-in Gains (see S Corp 050000 - Built-In Gains)
Selling Shareholders' flow-through gain or loss from Old Target may be California source income or loss.
Selling Shareholders' capital gain or loss on stock exchange is sourced at the shareholders' residence in the case of an individual shareholder.

a. IRC §1245 Recapture:

When a corporation sells IRC §1245 assets with accumulated depreciation and realizes gain, a portion of the gain must be classified as ordinary income instead of IRC §1231 gain. This is called IRC §1245 recapture. It is because the gain on sale of IRC §1245 assets is the result of the basis reduction by depreciation expenses (reducing ordinary income) and is not the result of appreciation. Therefore, it is fitting to characterize such gain as "ordinary" instead of "capital." The amount classified as ordinary income must be reported in the year realized and must not be deferred under the installment method pursuant to IRC §453(i)(1)(A).

Taxpayers tend to allocate more of ADSP to goodwill and less to Class III assets, to reduce the amount of possible IRC §1245 recapture. Therefore, it is imperative that auditors carefully analyze the fair market value of each class/type of asset. Refer to the valuation training material for the discussing of FMV and how to determine FMV.

b. BIGs:

If the target corporation is an S corporation with unrealized built-in gain at the time of S election, auditors should be concerned with the built-in gain issue. Although IRC §338(h)(10) triggers deemed sale of assets by the target corporation, all tax provision applicable in true sale of assets applies to the deemed sale of assets, including the built-in gain tax provision. Please refer to Chapter 5.0 Built-in Gains for details.

c. Selling Shareholders' Flow-Through Gain or Loss

Under IRC §1366(b), the character of flow-through gain/loss that resulted from the deemed sale of assets is decided at the corporate level. If Target has California source income, the sourcing passes through to the shareholders. Even a non-California resident shareholder must report his/her share of flow-through gain/loss on deemed sale of assets. (See California Court of Appeal, Fourth Appellate District, Division One, Gene Valentino et al. v. Franchise Tax Appeal Board) As in the case of *Valentino*, often non-California resident shareholders exclude their share of flow-through gain (on deemed sale of assets) from California taxable income by classifying the income as income recognized on sale of stock -- intangible asset. However, such treatment is erroneous. If a valid IRC §338 election is in place, the transaction is treated as a sale of assets by Target Corporation and not as sale of stock by the shareholders.

d. Selling Shareholders' Capital Gain/Loss on Target Liquidation

Under IRC §§338(h)(10) and 331(a), shareholders compute gain/loss as if they had exchanged stock for deemed liquidating distributions. The shareholders' amount realized is the stock price; their adjusted basis is their basis in the stock sold.

As mentioned above, because the shareholders' stock basis received an increase when they reported flow-through gain on deemed sale of assets by the corporation, the selling shareholders avoid double taxation on the gain by electing IRC §338(h)(10).

Unlike flow-through gain, the character of gain/loss realized on deemed liquidating distributions is decided at the shareholder level, following Personal Income Tax law. Therefore, non-California resident individual shareholders report the gain/loss on deemed liquidating distributions to the state they live in, not to California.

In a case where the selling S shareholders are non-residents and the installment method of income recognition was used to report income, the character of the gain/loss reportable by the non-resident shareholders on installment payments should be determined pursuant to IRC §453B(h)(1) and (2) and IRC §1366(b).